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(16)

No. 06-1413 12-27-07

In The
Supreme Court of the United States

MEADWESTVACO CORPORATION, SUCCESSOR IN INTEREST TO THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

REPLY BRIEF OF PETITIONER

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REPLY BRIEF OF PETITIONER

Mead paid taxes to Illinois, as a nondomiciliary corporation, based on the amount of Mead's income that was apportioned to its business conducted in Illinois. That taxation was based on the well-established proposition that a State can tax a corporation on its income attributable to business conducted within the taxing State. But respondents also required Mead to pay taxes based on a capital gain that was not apportionable to Illinois.

Respondents urge this Court to expand the reach of Illinois's tax authority and allow Illinois to include in Mead's apportionable tax base the capital gain derived by Mead from its out-of-state sale of its Lexis/Nexis investment. That capital gain, however, was earned by Mead in the course of activities unrelated to Mead's business conducted in Illinois. It was extraterritorial income not fairly attributed to the activities of the taxpayer Mead within the State. It was not income in the regular course of Mead's unitary business in Illinois, nor did it serve an operational function for that business.

This Court's precedents make clear that respondents cannot expand the reach of Illinois's taxing authority, consistent with the Due Process and Commerce Clauses, in such circumstances to allow the State to tax a nondomiciliary investor for a portion of a capital gain derived from the sale of a nonunitary investment.

I. RESPONDENTS' DEFENSE OF THE STATE COURT'S OPERATIONAL FUNCTION TEST IS MERITLESS

The sole justification of the state courts below for allowing Illinois to include in Mead's apportionable tax base the capital gain earned by Mead on the sale of Lexis/Nexis was that Mead's investment in Lexis/Nexis somehow served an operational function for Mead's paper and office supply business. But respondents devote only a small fraction of their brief to an attempt to defend that ruling. They rely on the single fact that Mead owned Lexis/Nexis and expected a return on that investment. That rationale does not meet the constitutional standard for operational function under *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

A. Respondents' Argument Is Contrary To *Allied-Signal*

Respondents are wrong that the state apportionment method of taxation is constitutional whenever the taxpayer corporation exerts some control over a nonunitary asset that produces out-of-state income or gain. Resp. Br. 40-45.

This Court has held that, unless there is a unitary business relationship between a taxpayer corporation and an asset in an out-of-state capital transaction, a State may tax an apportionment of the

gain derived from the asset *only if* that "capital transaction serve[s] an operational rather than an investment function" for the taxpayer's business conducted in the State. *Allied-Signal*, 504 U.S. at 787. In other words, the operational function test allows Illinois to tax an apportionment of Mead's capital gain on its sale of its Lexis/Nexis electronic data retrieval investment only if Lexis/Nexis was somehow used by Mead to serve an operational function for Mead's paper and office supply business conducted in Illinois. In the absence of such an operational relationship, the constitutionally required minimum connections between the State and the taxpayer's gain are not satisfied.

It is not enough that Mead's ownership of Lexis/Nexis affected Mead's balance sheet. *Allied-Signal* specifically cautioned that "the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one." *Ibid.* And, a nonunitary asset does not become integral to the operations of a unitary business merely because that asset is "'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.'" *Id.* at 789 (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 326 (1982)).

The *Allied-Signal* Court emphasized why this is so: "The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently *all* of its

operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business.'" *Ibid.* The Court unequivocally rejected that unlimited concept as satisfying the constitutional standard. *Ibid.*

B. Respondents Cannot Prevail Based On The Standard Of Review Because The State Court Applied The Wrong Legal Standard For Operational Function

1. Respondents argue that the judgment below should be affirmed because the standard of review that this Court applies requires deference to state courts. Resp. Br. 40.[1]

No deference to a state court ruling is appropriate, however, where, as here, the court applied the wrong legal standard. This Court has made clear that first its "task must be to determine

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[1] Certain of respondents' *amici* also suggest that Mead's arguments before this Court shift the burden of proof to Illinois to prove its tax is constitutional. Br. of California et al. as *Amici Curiae* Supporting Respondents 28-30. Mead makes no such argument. Under the applicable standard, Mead has the burden of proof to demonstrate that the state tax was unconstitutional. But, as discussed in Mead's opening brief and in this reply, Mead fully met this burden through undisputed evidence. J.A. 10-13. It thus is incumbent upon respondents to rebut Mead's proffer or have its tax found unconstitutional.

whether the state court applied the correct standards to the case," and then, only if the state court did so, it must determine whether the state court's "judgment 'was within the realm of permissible judgment.'" *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 176 (1983) (quoting *Norton Co. v. Department of Revenue*, 340 U.S. 534, 538 (1951)). Thus, absent application of the correct legal standard by the court below, this Court does not owe deference to the state court judgment.

That is so here. The Illinois appellate court's judgment on operational function does not merit deference because that court applied the wrong legal standard. The court employed an ad hoc approach that cited some connections between the two businesses and some benefits they shared. The court rested its operational function ruling simply on Mead's ownership of Lexis/Nexis, Mead's occasional "involvement with Lexis/Nexis," and basic indicia of ownership. Pet. App. 12a-13a.

But the correct legal standard for operational function under *Allied-Signal* does not rest on such facts. *Allied-Signal* requires that a court look to whether Lexis/Nexis provided integral support to the operations of Mead's paper and office supply business conducted in Illinois. 504 U.S. at 789. And, as Mead's opening brief explains, the facts regarding the relationship between Mead's paper and office supply business and its Lexis/Nexis investment do not satisfy that test. Pet. Br. 30-41.

2. Respondents attempt to distinguish *Allied-Signal* on the ground that the taxpayer in that case "owned only 20.6% of its investee's stock and had no way to control the investee." Resp. Br. 44. But that fact was not relevant to the operational function inquiry in *Allied-Signal*. Rather, the Court cited the fact to support its conclusion that the taxpayer's minority stake in the investment meant that there was no possibility of "an integrated division of a single unitary business." *Allied-Signal*, 504 U.S. at 788. And even in the context of a unitary business relationship, this Court made clear that "potential control is not sufficient." *Ibid.* (citing *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354, 362 (1982)).[2]

3. Respondents also contend that the extent of its taxation of Mead can be justified because, they claim, "Mead regularly manipulated Lexis/Nexis's corporate form" to gain tax benefits. Resp. Br. 41. That post hoc justification based on corporate form is wrong for three reasons.

First, respondents' statement is belied by the facts to which respondents agreed through stipulation.

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[2] In *Woolworth*, for example, this Court invalidated an application of a state tax apportionment scheme even though three of the four subsidiaries the State sought to tax were 100% owned by the taxpaying parent. *Woolworth*, 458 U.S. at 356-357. Accordingly, not only does petitioner's 100% ownership have no relevance to the operational function test, it also is of limited probative value to the unitary business determination.

The stipulated record establishes that, in the twenty-six years during which Mead owned Lexis/Nexis, such a change occurred on only three occasions. J.A. 14. Far from demonstrating any "regular[]" manipulation of corporate form, those infrequent occurrences do not indicate that Lexis/Nexis somehow operationally supported Mead's paper and office supply business.[3]

Second, respondents' argument that the change in the corporate form of Lexis/Nexis was not "arm's length" (Resp. Br. 41) is nonsensical. Mead owned a 100% interest in Lexis/Nexis both before and after the change in corporate form. Moreover, the record does not support respondents' implication that there was a sale of Lexis/Nexis for $350,000; rather the record indicates that was the cost of effecting the corporate change. J.A. 147. The change in corporate form had no substantive effect on the operations at Lexis/Nexis vis-à-vis Mead. J.A. 165, 176-177.

Third, this Court has never placed significance on the corporate form of an asset but, instead, has focused on the activity of the asset to determine whether it served an operational function for the

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[3] Respondents' reliance on this fact also is undermined by their own insistence, starting in 1988, that Mead and Lexis/Nexis file consolidated tax returns in Illinois as a unitary business, which Mead did under protest. J.A. 13. Accordingly, the 1993 change in corporate form had no effect on Mead's taxes in Illinois, because Mead already was filing in that manner at the insistence of Illinois.

entity being taxed. *Cf. Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 440 (1980) ("the underlying activity, not * * * the form of investment * * * determine[s] the propriety of apportionability"). Respondents elsewhere concede as much. *See* Resp. Br. 43 ("Apportionment has nothing to do with the form a business organization takes.").

Respondents' *amici* make a somewhat similar argument, contending that Illinois can apportion to itself for taxing purposes part of the gain Mead received from the sale of Lexis/Nexis because the change in the form of Lexis/Nexis had "the purpose of setting off against the gains of one part of the business the losses incurred by another part." Br. of California et al. as *Amici Curiae* Supporting Respondents 31.[4] Their argument would eviscerate the operational function test. It would mean, as a practical matter, that a State would be entitled to increase its tax on a nondomiciliary corporation conducting a business in the State to include a variety of transactions involving the corporation's investments located in other States. That would be so whenever the corporation realized a tax benefit from its ownership of such out-of-state subsidiaries and

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[4] Neither Illinois nor its *amici* cite any case to support their extraordinary proposition that tax benefits that affect only a multistate corporation's balance sheet can serve an operational function. Our research has located only one case addressing that issue and it did so in the context of state law. *See Kewanee Indus., Inc. v. New Mexico*, 845 P.2d 1238 (N.M. 1993).

divisions even though those investments were not otherwise related to the corporation's unitary business conducted in the State. The practical and unsettling effect of such a result is explained in detail by *amicus curiae* in support of Mead's opening brief. *See* Br. of The Walt Disney Company as *Amicus Curiae* Supporting Petitioner 22-26; *see also* Pet. Br. 43-50.

C. Respondents Improperly Conflate The Operational Function Test And The Unitary Business Test

Respondents and their *amici* States confuse this Court's precedents when they claim that the operational function test is not distinct from the unitary business test, and is a mere component of the latter test. Resp. Br. 43-44; Br. of California et al. as *Amici Curiae* Supporting Respondents 14-21.

Significantly, this is a distinction without a difference, because such mislabeling cannot alter the fact that the state tax here fails under either approach. *See* pages 13-21 *infra* (unitary business); Pet. Br. 21-28 (same); *see* pages 4-9 *supra* (operational function); Pet. Br. 28-41 (same).

In any event, respondents' effort to blur the distinction between the two tests is misleading because, irrespective of whether the two tests are independent of one another or are components of a larger analysis, they each are distinct in that they measure in different ways the relationship between the taxpayer and the asset or investment that the

State seeks to tax. The unitary business test examines whether an asset is an integrated part of the taxpayer's business. The operational function test examines whether an asset that is not integrated with the taxpayer's business nonetheless provides integral operational support to the business.

By conflating the two tests, respondents seek to satisfy the operational function test based on evidence that shows no more than some economic connection between two businesses under common ownership. That evidence does not, as demonstrated above, meet the operational function test and, although it is probative it is not sufficient under the unitary business test.[5] Respondents appear to imply (Resp. Br. 44) that because, in their view, the two tests are not mutually exclusive, evidence of partial satisfaction of both tests can satisfy the constitutional standard, but that is clearly contrary to *Allied-Signal*.

Other than the court below, state courts have universally recognized that the operational function test is not satisfied merely because a nonunitary

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[5] We do not suggest that evidence probative of a unitary business relationship could not also be probative of an operational function. For example, it might be probative to both inquiries if the record demonstrated that the two businesses were in the same line of business. But what respondents ignore is that such evidence would be probative to both tests for different reasons, because of the different analyses each test employs.

asset contributes to a taxpayer's "financial strength overall," because to do so "would swallow the distinction between operational and investment income." *Alaska Dep't of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399, 411, 414 (Alaska 1998). State court decisions sustaining state apportionment under the operational function test share no similarities to the instant case. *Pennzoil Co. v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001), *cert. denied*, 535 U.S. 927 (2002) (agreement guaranteeing strategic petroleum resources for taxpayer petroleum business constitutes an operational function); *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 345 (Cal.), *cert. denied*, 534 U.S. 1040 (2001) (trust and pension plan served an operational function because it was designed "to induce [the taxpayer's] current employees to stay and to attract new employees").[6] Taxation of the nonunitary asset's income or gain is justified in those cases because the income or value derived therefrom is used in an ongoing, integral operational capacity by the taxpayer's unitary business conducted in the taxing state.

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[6] *Allied-Signal* and state courts applying the operational function test also rebut respondents' claim (Resp. Br. 44) that the "flow of benefits" from Mead to Lexis/Nexis is relevant to the test. None of those cases describe a circumstance in which the operational function test would be satisfied due to a taxpayer's support of its nonunitary asset. Thus, it is respondents' argument that "finds no support in the caselaw." *Ibid.*

Respondents are wrong to challenge the fact that the operational function test is a narrow exception to the unitary business principle's limit on State taxation of out-of-state income. Resp. Br. 41-42. The narrow scope of the operational function test is demonstrated by the very limited circumstances in which it can sustain a state tax apportionment scheme. As Illinois concedes, this Court in *Allied-Signal* proffered just two examples: "interest on short-term deposits in out-of-state banks, where the interest is used as working capital"; and an investment "which ensured a supply of a producer's key ingredient." Resp. Br. 42.[7]

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[7] It was not until 1992, in *Allied-Signal*, that the Court applied, for its first and only time, the operational function test. The Court in *Container Corporation of America v. Franchise Tax Board* had articulated, but had not applied, the operational function test by citing an example where it might be satisfied based upon a case arising "in another context." 463 U.S. 159, 180 n.19 (1983). Other cases from that era challenging state tax apportionment methods were all resolved based on whether a unitary business relationship existed. *See ASARCO*, 458 U.S. 307; *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980); *Woolworth*, 458 U.S. 354.

By contrast, this Court first set forth the unitary business test more than one hundred years ago. The Court allowed States to treat railroads that traversed several jurisdictions "as a unit" for tax purposes and then to apportion the value of that multistate "unit" to individual States. *State R.R. Tax Cases v. Kidder*, 92 U.S. 575, 608 (1875). This was so because the various components of the railroad present in each jurisdiction did not, in isolation, possess significant value. It was only by allowing States to consider the components in the various jurisdictions in the aggregate that the true value of the railroad as a whole

(Continued on following page)

II. RESPONDENTS' CHALLENGE TO THE TRIAL COURT'S UNITARY BUSINESS RULING FAILS

A. The Trial Court Correctly Concluded That There Was No Unitary Business Relationship Between Mead And Lexis/Nexis

Respondents argue that the trial court erred when it ruled that there was no unitary relationship between Mead and Lexis/Nexis. Resp. Br. 34-40. Although the Illinois appellate court declined to reach the issue, Pet. App. 11a, the trial court thoroughly examined the question and unequivocally and correctly resolved it in Mead's favor, Pet. App. 39a.[8]

As already noted above, and as Illinois acknowledges (Resp. Br. 40), this Court "will, if

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could be discerned and a State could tax a fairly apportioned part of it. *Ibid.*; *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1897); *see also Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120 (1920) (upholding against constitutional challenge state apportionment method because "the profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sales in other states"); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282 (1924) (same).

[8] This issue is not a necessary predicate to resolution of the question presented because the operational function test is resolved separately from the unitary business test. *Allied-Signal*, 504 U.S. at 787. Illinois, however, asks this Court to address the issue, Resp. Br. 34-40, and noticed the issue in their brief in opposition, *see* Br. in Opp. 7, 9 n.3 (discussing test and relying on its cases), and before the Illinois trial and appellate courts, so the record allows review of the issue.

reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a 'unitary business.'" *Container Corp.*, 463 U.S. at 175. Thus, if the state trial court applied the correct legal standard, the Court will grant deference to its conclusion if that conclusion "was within the realm of permissible judgment." *Id.* at 176 (quoting *Norton Co.*, 340 U.S. at 538).

The trial court here applied the correct legal standard to determine whether a unitary business relationship existed between Mead and Lexis/Nexis. Pet. App. 39a. The court examined whether Mead and Lexis/Nexis were "functionally integrated," shared "centralization of management," or evidenced "significant economies of scale between the two businesses." This substantive standard is identical to the one repeatedly applied by this Court. *Allied-Signal*, 504 U.S. at 789 (noting that the "hallmarks" of the unitary business test are "functional integration, centralization of management, and economies of scale"); *Container Corp.*, 463 U.S. at 179; *ASARCO*, 458 U.S. at 317; *Mobil Oil*, 445 U.S. at 438.

The trial court found that none of these three critical indicia of a unitary business existed in the instant case. Pet. App. 39a. That determination fell well "within the realm of permissible judgment"; indeed, the ruling is overwhelmingly supported by the record.

The trial court's ruling that Mead and Lexis/Nexis "were not functionally integrated" was

demonstrated by the fact that the two lines of business maintained separate departments and facilities. Pet. App. 35a. This was supported by the facts to which respondents stipulated that established that Mead and Lexis/Nexis maintained separate legal departments, financial staff, accounting departments, audit departments, credit and collection departments, human resources departments, marketing departments, computer systems, bank accounts, and personnel. J.A. 10-13. In light of this overwhelming evidence, the trial court concluded that Mead's "involvement for extraordinary purchases requiring capital investment and the interest rate advantage gained by Mead through the nightly sweep of bank accounts is not sufficient evidence that the two were functionally integrated." Pet. App. 35a.

Similarly, based upon those stipulated facts, the state trial court determined that "Mead and Lexis/Nexis did not share a centralized management." Pet. App. 36a. The trial court ruled that that evidence was not rebutted by Mead's approval of certain "extraordinary purchases" and Mead's consideration of Lexis/Nexis in its "strategic planning." *Ibid.*

Finally, the trial court held that "[t]here were no economies of scale realized by Mead and Lexis/Nexis" because the two businesses "had separate purchasing departments and no joint purchasing activities." *Ibid.* Neither business even offered the other any discount on the products or services of the other. *Ibid.* In fact, "Lexis/Nexis often bought paper from other vendors." *Ibid.* As such, the only plausible economy of scale the

two businesses realized was the "increased interest rate" due to nightly cash sweeps, *ibid.*, which paled in comparison to the stipulated facts demonstrating the lack of a unitary relationship. Pet. App. 35a-36a; J.A. 10-13.

Respondents now attempt to overturn these rulings by ignoring the stipulated facts to which they agreed in the trial court, but those facts are dispositive of the unitary business test. They unequivocally establish that "Mead was, and is, in the business of producing and selling forest products" and that "Lexis/Nexis provided online information services for legal, news and financial information in the electronic publishing market." J.A. 9-10. Although Mead owned Lexis/Nexis, "Lexis/Nexis had its own full-time management to control its day-to-day operations." J.A. 13. The two divergent businesses had separate departments for every function, and the two businesses did not share personnel or any financial staff. J.A. 10, 13. The two businesses maintained separate and distinct training programs, computer systems and bank accounts. J.A. 11-12.

B. Respondents Misconstrue The *Container Corporation* Ruling

1. Respondents invoke *Container Corporation* in an attempt to turn the Mead paper and office supply business and the Lexis/Nexis online information service into one unitary business. Resp. Br. 34.

Respondents' reliance on *Container Corporation* is misplaced because this Court in *Allied-Signal* explained that in *Container Corporation*, the hallmarks of the unitary business relationship remained functional integration, centralization of management, and economies of scale. *Allied-Signal*, 504 U.S. at 789. *Container Corporation* demonstrated that these essentials could be shown through "transactions not undertaken at arm's length; a management role by the parent that is grounded in its own operational expertise and operational strategy; and the fact that the corporations are engaged in the same line of business." *Ibid.* (citing *Container Corp.*, 463 U.S. at 178, 180 n.19). None of those factors are present in the instant case. *See* J.A. 10-13.

Indeed, respondents begrudgingly recognize one of these significant distinctions between the instant case and *Container Corporation*, *i.e.*, "the taxpayer in [*Container Corporation*] was engaged in the same basic line of business as its subsidiaries." Resp. Br. 37. Although respondents try to discount that distinction as "immaterial," *ibid.*, that fact was critical to the Court's holding. The Court indicated that it was reasonable to presume that two related corporations engaged in the same line of business are unitary. The Court explained that, where "a corporation invests in a subsidiary that engages in the same line of work as itself," "it becomes much more likely that one function of the investment is to make better use—either through economies of scale or through operational integration or sharing of

expertise—of the parent's existing business-related resources." *Ibid.* The Court contrasted that with the situation where, as here, there is an "[i]nvestment in a business enterprise truly 'distinct' from a corporation's main line of business," which "often serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle." *Container Corp.*, 463 U.S. at 178.

Container Corporation demonstrates the practical implications of this reasoning because the technical assistance and equipment that the parent in that case shared with its subsidiary were unquestionably of significant value due to the fact that the parent and its subsidiary were in the same line of business. *Id.* at 172 (noting that "groups of foreign employees occasionally visited the United States for 2-6 week periods to familiarize themselves with [the taxpayer's] methods of operation" and that five executives of the taxpayer were charged "with the task of overseeing the operations of the subsidiaries");[9] *id.* at 173

[9] Exchanges of personnel, training programs, or day-to-day executive oversight did not occur between Mead and Lexis/Nexis. J.A. 10-13. Respondents identify three executives who worked for both businesses at some point. Resp. Br. 7. In fact, the record indicates that only a half dozen of 4000 Lexis/Nexis employees ever worked at Mead. J.A. 173. There is no evidence that even these were *strategic* transfers of personnel by Mead. Rather, the evidence supports the opposite conclusion because one of the three executives testified that he moved to Mead simply because he wanted to leave Lexis/Nexis for "personal" reasons. *Ibid.*

(explaining that parent could "provide[ ] advice and consultation regarding manufacturing techniques, engineering, design, architecture, insurance, and cost accounting" to its subsidiaries); *id.* at 179 (relying on the "'substantial' technical assistance provided by [the parent] to the subsidiaries"); *see also Exxon Corp.*, 447 U.S. 207 (subsidiaries in the same line of business as parent); *Mobil Oil*, 445 U.S. 425 (same).

2. Mead's infrequent approval of major capital expenditures by Lexis/Nexis, J.A. 15-16, bears no similarity to the manner in which the taxpayer in *Container Corporation* assisted its subsidiaries. Resp. Br. 35. Unlike the acquisition of computer equipment in the instant case, the assistance provided by the parent in *Container Corporation* was extensive because the parent "assisted its subsidiaries in their procurement of equipment, either by selling them used equipment of its own or by employing its own purchasing department to act as an agent for the subsidiaries." *Container Corp.*, 463 U.S. at 173. Thus, in contrast to *Container Corporation*, Mead's conduct here was the "type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary," without creating a unitary business. *Woolworth*, 458 U.S. at 369.[10]

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[10] Respondents argue that Mead was run "in a decentralized fashion" (Resp. Br. 6), implying that Mead's hands-off approach toward Lexis/Nexis supports a unitary business relationship between the two. The record demonstrates, however, that

(Continued on following page)

Tellingly, respondents repeatedly assert that there was control of Lexis/Nexis by Mead, but they do not have accurate record support. Respondents argue that Mead "reviewed" the business plan of Lexis/Nexis, Resp. Br. 27, but the testimony they cite demonstrates only that once a year Lexis/Nexis would "explain [its] business plan and that was pretty much it." J.A. 163. Moreover, respondents contend that "Mead, not Lexis/Nexis, decided how to invest Lexis/Nexis's excess cash." Resp. Br. 27. The trial testimony cited by respondents, however, demonstrates that Lexis/Nexis "could have set up the banking relationships * * * but *chose* not to." J.A. 181 (emphasis added).[11]

Respondents' claim that Mead and Lexis/Nexis must be considered a unitary business because Mead submitted a consolidated tax return to Illinois is meritless. Resp. Br. 4-5, 9, 38. As Illinois conceded by stipulation, and the trial court recognized, the consolidated tax return came about because Illinois required Mead to file such a return and Mead did so only to settle that dispute. J.A. 13; Pet. App. 39a

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Lexis/Nexis "was much more independent than other divisions of * * * Mead." Ill. C.A. Rec. Vol. 9 at 112. Unlike Lexis/Nexis, which "always had their own," Mead's other divisions "shared services, procurement, HR, computer systems, things of that nature." *Ibid.*

[11] Respondents also cite to Mead's approval of compensation and bonuses for certain Lexis/Nexis executives. Resp. Br. 27 (citing J.A. 146). But the record demonstrates that Mead did so for only a handful of the thousands of Lexis/Nexis employees. J.A. 13.

(noting the filing was "at the direction of" respondents and not probative).[12] Respondents' current position would require all nonunitary divisions of a multistate corporation that are included in a consolidated return to be *per se* taxable as part of the taxpayer's unitary business, in conflict with the decisions of this Court. *Mobil Oil*, 445 U.S. at 440.[13]

III. RESPONDENTS WAIVED THEIR MERITLESS ARGUMENT THAT THE RELATIONSHIP BETWEEN LEXIS/NEXIS AND ILLINOIS ALLOWS RESPONDENTS TO TAX MEAD'S CAPITAL GAIN

Respondents contend that the Constitution permits a State to tax an out-of-state investor's capital gain based solely on ties between the *investment* and the taxing State. Resp. Br. 18-31, 46-49; *see also* Br. of Multistate Tax Commission as *Amicus Curiae* Supporting Respondents 17-19 (MTC Br.). Under this argument, a State could impose a capital-gains tax on an investor even if the investment is not part of the

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[12] Because States employ different standards as to when a corporation and its subsidiaries must file a consolidated versus a separate return, what state law requires cannot dictate what the Constitution permits or else the limits of the Due Process and Commerce Clauses would be meaningless.

[13] Respondents argue that Mead had "leeway as to how it characterizes its business" in its reports and filings. Resp. Br. 30. But such "leeway" would not have permitted Mead to not report ownership of Lexis/Nexis as an electronic publishing business. Moreover, this Court places little significance on such reports. *Woolworth*, 458 U.S. at 369 n.22.

investor's unitary business and did not serve an operational function.

A. Respondents Failed To Preserve This Argument In The State Appellate Court

Respondents repeatedly argue in their brief to this Court that the relationship between Lexis/Nexis and Illinois alone justifies Illinois's tax on Mead's capital gain. Resp. Br. 18-31, 46-49. But respondents did not raise this argument in the state appellate court (and the court did not raise the issue *sua sponte*). Rather, respondents argued that there were "two circumstances" where the Constitution permitted the State to apportion to itself for taxation a part of Mead's capital gain from its Lexis/Nexis sale: (1) if Mead and Lexis/Nexis had a unitary business relationship and (2) if Mead's investment in Lexis/Nexis served an operational function. C.A. Br. of Illinois 24-25.

Respondents thus waived under state law the argument they now press that a connection between the *investment* and the State sustains the Illinois tax. A party that fails to raise an argument in the Illinois appellate court waives that argument by operation of state law. *See* Ill. S. Ct. R. 341(h)(7), (i) (points not argued by the appellee are waived); *Elementary Sch. Dist. 159 v. Schiller*, 849 N.E.2d 349, 358 n.2 (Ill. 2006) (appellee must raise all arguments it wishes to preserve in its brief).

That waiver in state court bars respondents from bringing the issue to this Court, because an alternative ground for affirmance is waived in this Court if it was not raised in, nor passed upon by, the appellate court below. *See, e.g.*, *Glover v. United States*, 531 U.S. 198, 205 (2001) (refusing to consider alternative arguments for affirmance that were not raised in court of appeals); *Heckler v. Campbell*, 461 U.S. 458, 468 n.12 (1983) (same); *McGoldrick v. Compagnie Generale Transatlantique*, 309 U.S. 430, 434 (1940) (same with respect to state courts).[14]

B. This Argument Raises Issues That Could Affect Other States Who Were Not On Notice Of The Argument From The *Certiorari*-Stage Briefing

Respondents' argument based on Lexis/Nexis's connection to the State as a justification for Illinois's taxation of Mead's capital gain also should not be addressed by this Court because it asks this Court to reach out and decide a constitutional question that has limited relevance to the ordinary operation of the Illinois taxation scheme, and one that could directly

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[14] As respondents point out, Resp. Br. 23 n.7, they may urge affirmance on any ground supported by the record. But an argument that was not preserved in the appellate court is waived. *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 578 (2001) (Thomas, J., concurring in part and concurring in the judgment) (The Court does "not consider arguments for affirmance that were not presented below.").

affect other statutory schemes that are not before this Court. *Illinois v. Gates*, 462 U.S. 213, 221, 224 (1983); *Roberts v. Galen of Virginia, Inc.*, 525 U.S. 249 (1999) (per curiam).

With respect to the taxation of capital gains from intangible investments (such as from the sale of Lexis/Nexis), Illinois's taxation scheme does not turn on whether the investment has ties to Illinois. Rather, under Illinois law, apportionability of such a gain depends upon the relationship between the investment and the taxpayer. *See* 35 Ill. Comp. Stat. Ann. 5/303(a), (b)(3), 5/304(a) (West 1994); Pet. App. 15a. In the absence of a sufficient connection between the investment and the taxpayer *under state law*, Illinois does not tax the capital gain, regardless of whether or not ties exist between the investment and the State. Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* § 9.11[2][a] (3d ed. 2007).

By contrast, States such as New York calculate their tax based on the relationship between the investment and the State. *See, e.g.*, N.Y. Tax Law § 210(3)(b) (Consol. 2007); *In re Allied-Signal, Inc.* (*Allied-Signal II*), 645 N.Y.S.2d 895, 898 (N.Y. App. Div.), *appeal dismissed*, 675 N.E.2d 1234 (N.Y. 1996); Hellerstein, *supra*, at § 9.11[2][a]. Such States have a much greater interest in this waived argument, because the constitutional permissibility of such taxation schemes rises and falls upon respondents' argument.

The States that could be greatly affected by resolution of this argument were not on notice to participate as *amicus* on this issue and, for example, New York did not do so.[15] Respondents did not raise this argument in their brief in opposition, which alone should preclude this Court's consideration, S. Ct. R. 15.2.[16]

C. Reliance On An Investment's Relationship With The Taxing State To Tax An Investor Cannot Be Squared With This Court's Precedents

Respondents' argument that Illinois may tax Mead for its capital gain based solely on a connection between Lexis/Nexis and Illinois is without merit.

Respondents cannot prevail on this argument based merely on their repeated citation (and that of their *amici*) to general principles of constitutional law with which petitioner has no disagreement—that a State can tax a taxpayer with which it has minimal

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[15] After this Court decided *Allied-Signal*, the constitutionality of New York's scheme of taxing investors based on the relationship between the investment and the State was challenged. *See Allied-Signal II*, 645 N.Y.S.2d at 898-899. An intermediate state appellate court rejected that challenge, *ibid.*, and the New York Court of Appeals declined review, 675 N.E.2d 1234. No *certiorari* petition was filed.

[16] Indeed, respondents even rephrased the question presented in their brief in opposition, but neglected to raise the argument that they now press and which they had waived in the state appellate court.

connections and to which it provides opportunities, protections, and benefits, Resp. Br. 18, 23, and that "an out-of-state company is subject to tax in any State in which it conducts business," *id.* at 46. In fact, such taxes were paid here on an apportioned share of Lexis/Nexis's income earned in Illinois, as well as on an apportioned share of Mead's income earned in Illinois. Respondents, however, would expand the State's taxing authority far beyond that.[17]

1. Respondents' position is foreclosed by *Allied-Signal*, where this Court addressed circumstances virtually identical to the instant case—*i.e.*, a State's taxation of a nondomiciliary company's capital gain resulting from the sale of an investment that also did business in the taxing State. Specifically, in *Allied-Signal* a nondomiciliary taxpayer challenged New Jersey's tax on its capital gain arising from the sale of an investment (stock). 504 U.S. at 773-774. Just as in the instant case, the investment did business in New Jersey (and, in fact, was a New Jersey corporation). *Ibid.*

The connection between the investment and the taxing State did not preclude this Court from invalidating the tax on the nondomiciliary investor

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[17] The suggestion of *amicus* MTC that the goodwill taxed here had a taxable business situs in Illinois (MTC Br. 21-23) is wrong. The cases cited by MTC involve intangible property of the taxpayer's unitary business. *Adams Express*, 165 U.S. at 219. Passive investments are not subject to the business situs principle. *Id.* at 222.

as unconstitutional under both the unitary business and operational function tests. As the *amici* States concede (Br. of California et al. as *Amici Curiae* Supporting Respondents 12), the relevant constitutional inquiry under *Allied-Signal* "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and [the taxpayer's] activities within the taxing State," 504 U.S. at 785, not on the relationship between the asset and the taxing State.

2. The authorities that respondents cite do not hold otherwise. Respondents rely heavily on *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944), and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940), as purportedly justifying their argument that Lexis/Nexis's connection to Illinois is enough to tax Mead for the capital gain on its sale of Lexis/Nexis. But neither of those cases supports respondents. Those cases stand for the unremarkable proposition that a State has the power to tax a business for its share of income that the business earned within its borders.

Both cases arose because of a Wisconsin law that required corporations doing business in that State to pay a tax on dividends distributed to shareholders. *Int'l Harvester*, 322 U.S. at 437; *J.C. Penney*, 311 U.S. at 439-440. This Court upheld in both instances a Wisconsin tax on an apportioned share of the dividend, because the business was being conducted in the taxing State. *Int'l Harvester*, 322 U.S. at 438, 442; *J.C. Penney*, 311 U.S. at 440 n.1, 444-445. The Court reached this result because the tax in these

cases was a deferred income tax imposed on the corporation that did business within the State, and not on an out-of-state investor shareholder that received dividends. *Int'l Harvester*, 322 U.S. at 441 ("The power to tax the corporation's earnings includes the power to postpone the tax until distribution of those earnings * * * ."); *id.* at 447 (Jackson, J. dissenting) (explaining that the majority can sustain the tax because it is "an income tax on the corporation, deferred until the income was distributed," even though the dissent views that it "is not an income tax * * * but is a tax on the stockholder"); *J.C. Penney*, 311 U.S. at 442 ("The practical operation of this legislation is to impose an additional tax on corporate earning within Wisconsin but to postpone the liability for this tax until earnings are paid out in dividends."). In the instant case, by contrast, Illinois is taxing the out-of-state investor, Mead, rather than its investment, Lexis/Nexis.

These precedents are consistent with this Court's unitary business and operational function precedents. In *Allied-Signal* and its predecessor decisions, just like *International Harvester* and *J.C. Penney*, this Court permitted a State to tax a company on the apportioned share of the income (or dividends) that are directly attributable to the company's unitary business in the State. But this Court's precedents do not support the proposition that a State can tax a company on an apportioned share of a capital gain that is unrelated to the company's unitary business conducted in that State, merely because the

investment associated with the gain has a connection to the taxing State.

Indeed, under respondents' theory, every out-of-state investor could have to pay taxes on the capital gain from a passive investment in every State where the investment does business. The Constitution certainly does not permit such a result.

IV. A Ruling In Respondents' Favor Would Upset Settled Expectations And Create A Risk Of Duplicative Taxation

A. Respondents propose an unconstrained rule so that a State may apportion "any gain realized from the sale of a subsidiary[ ] over which the taxpayer had considerable control and with which it dealt regularly." Resp. Br. 57. This rule would transform every wholly-owned subsidiary into an operational asset of the parent, and create chaos because States and corporations have relied upon this Court's well-settled principles to the contrary.

As this Court has recognized, state legislatures have relied on this Court's distinction between assets that serve an operational function and those that serve an investment function—the very distinction that Illinois seeks to eviscerate. *Allied-Signal*, 504 U.S. at 785 ("State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary State * * * ."). Multistate corporations likewise have relied on *Allied-Signal* in structuring transactions

with a degree of tax certainty. *See* Br. of The Walt Disney Company, as *Amicus Curiae* Supporting Petitioner 25-26.

The reliance placed upon this Court's precedent is demonstrated by the consistently narrow interpretation of the operational function test by state courts in the fifteen years since *Allied-Signal*. *OSG Bulk Ships*, 961 P.2d at 414. Other than the decision below, state courts have repeatedly held that an investment does not serve an operational function where it was used neither as a source of working capital nor as a hedge against a fluctuating supply of a key commodity. *See Hercules Inc. v. Commissioner of Revenue*, 575 N.W.2d 111, 117 (Minn. 1998); *Hercules Inc. v. Comptroller of Treasury*, 716 A.2d 276, 281-284 (Md. 1998) (observing that this Court "has not encompassed strategic, long-range decisions of a company within operational functions").[18] The drastic modification of the operational function test suggested by respondents "would disrupt * * * an area of the law in which the demands of the national

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[18] Respondents inexplicably suggest that the *Hercules* courts' determination of no-operational function was based on the fact that the taxpayer exercised no control over the asset. Resp. Br. 56-57. The issue of control was one factor (of many) in these courts' unitary-relationship analyses, 575 N.W.2d at 116; 716 A.2d at 280-281, but there was no discussion of exercise of control in the courts' application of the operational function test, 575 N.W.2d at 116-117; 716 A.2d at 281-284. Illinois's reliance (Resp. Br. 55) on the California Supreme Court *Hoechst Celanese* decision is also misplaced, as noted above, *see* page 11.

economy require stability." *Allied-Signal*, 504 U.S. at 786.

B. This case is not just about Illinois's attempt to tax an apportionment of Mead's capital gain. Resp. Br. 50. Under respondents' rule, every State where a corporation does business could tax an apportionment of the capital gain earned by that corporation from intangibles. Such taxing authority by nondomiciliary States would be in addition to the constitutional authority of the domiciliary State to tax the entirety of such a gain. *Mobil Oil*, 445 U.S. at 444 ("Taxation by apportionment and taxation by allocation to a single situs are theoretically incommensurate * * * .").

Such potential for double taxation is the final defeat for respondents. Contrary to their claim (Resp. Br. 50-51), this Court has never required evidence of duplicative taxation in a particular case to invalidate an unconstitutional taxing scheme that would allow such duplication. Indeed, the potential for double taxation was an express concern of the Court in *Allied-Signal*. *See* 504 U.S. at 785 ("Were we to adopt New Jersey's theory, we would be required" to "authorize what would be certain double taxation.").[19]

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[19] Respondents are wrong that *Kemppel v. Zaino*, 746 N.E.2d 1073 (Ohio 2001) dictates that Ohio would have apportioned the capital gain. That case concludes that, under Ohio law, capital gains from a business's total liquidation are allocated to the taxpayer's domicile. *Id.* at 1076-1077.

CONCLUSION

For the reasons set forth above and in petitioner's opening brief, the Court should reverse the judgment below.

Respectfully submitted,

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